No. 15339

IN THE

United States Court of Appeals

For the Ninth Circuit

AMERICAN TRUST COMPANY, a Corporation,
Plaintiff-Appellant,

vs.

JAMES G. SMYTH, Collector of Internal Revenue, and UNITED STATES OF AMERICA,
Defendants-Appellees.

BRIEF FOR PLAINTIFF-APPELLANT

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TABLE OF CONTENTS

Cases

Constitution and Treaties

Statutes

Regulations and Rulings

Miscellaneous

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APPELLANT'S OPENING BRIEF

APPEAL FROM THE UNITED STATES DISTRICT COURT, NORTHERN DISTRICT OF CALIFORNIA, SOUTHERN DIVISION

This is an action to recover Federal income taxes erroneously and illegally collected from plaintiff-appellant American Trust Company. There is no factual dispute; only legal questions are presented on this appeal.

Jurisdiction

The action was instituted in the United States District Court for the Northern District of California, Southern Division, and was tried before the Honorable Oliver J. Carter without a jury (R. 31).

The Complaint (R. 3) asserts three claims for relief, each of which is concerned with the same tax payments. All three claims arise under Section 22(b)(7) of the Internal Revenue Code, under the Income Tax Convention between the United States and the United Kingdom of Great Britain and Northern Ireland, 60 Stat. 1337, and under Sections 322, 3771 and 3772 of the Internal Revenue Code.[1]

The First Claim for Relief (R. 3) names as defendant James G. Smyth, a former Collector of Internal Revenue. The trial court had jurisdiction thereof by virtue of 28 U. S. C. §§ 1331 and 1340. The Second and Alternative Claim for Relief (R. 14) names as defendant the United States of America. This claim is in substitution of the claim against Smyth, who had retired and was not in office at the institution of the action (*Lowe Bros. Co.* v. *U. S.*, 304 U. S. 302, 305 (1938)), and the trial court had jurisdiction thereof by virtue of 28 U. S. C. §§ 1331, 1340 and 1346. The Third and Alternative Claim for Relief (R. 15) also names the United States as defendant, and the trial court had jurisdiction thereof by virtue of 28 U. S. C. § 1346.

From a judgment in favor of defendants (R. 49) entered on the trial court's findings of fact and conclusions of law (R. 31), plaintiff appealed (R. 50). This Court has jurisdiction to review the judgment under 28 U. S. C. §§ 1291 and 1294(1).

Statement of the Case

The plaintiff in 1946 was and still is the duly qualified trustee of a certain testamentary trust created under the will of Harry L. Tevis, late of the County of Santa Clara, California, who died testate on July 19, 1931 (R. 32). In 1946 the plaintiff, as such trustee, sold part of the property constituting the corpus of the trust at a profit (R. 33). It

[1] All references to the Internal Revenue Code are to the Internal Revenue Code of 1939 unless otherwise indicated.

duly filed a Federal income tax return, reporting the sale and the amount of profit and paid the Collector of Internal Revenue for the First District of California capital gain taxes of $570,957.86 (R. 33-4). Thereafter, a claim for refund was filed with the Commissioner of Internal Revenue, asserting that such taxes were erroneously and illegally collected (R. 34). The claim for refund was denied in full and this suit followed (R. 34).

Throughout 1946 all the life beneficiaries of the trust and all the remaindermen of the trust were residents of the United Kingdom of Great Britain and Northern Ireland and were not engaged in trade or business in the United States (R. 39-40, 41).

The question raised below and here presented is whether the capital gains here involved are exempt from United States tax under Article XIV of the United Kingdom Income Tax Convention as implemented by Section 22(b)(7) of our Internal Revenue Code.

The Court below held that capital gains realized by the trustee of a United States trust when currently distributable are exempt under the United Kingdom Convention, but that the capital gains when held for future distribution are not exempt (R. 24, 48-9).

The Statute, Treaty and Regulations

Section 22(b)(7) of our Internal Revenue Code provides broadly:

> "(b) Exclusions from gross income.—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:
>
> * * *
>
> (7) Income exempt under treaty.—Income of any kind, to the extent required by any treaty obligation of the United States."

The exemption here claimed arises under the Income Tax Convention with the United Kingdom and depends upon a consideration of the Convention in its entirety. In particular, Article XIV provides:

> "A resident of the United Kingdom not engaged in trade or business in the United States shall be exempt from United States tax on gains from the sale or exchange of capital assets."

The official text of the treaty is printed in full in our Appendix separately bound. We also print in our Appendix the material parts of Sections 161 and 162 of the Revenue Code of 1939 as they appeared in 1946, upon which the Court below mainly relied in reaching its decision.

Treasury Decision 5569 comprises the Commissioner's Regulations applicable to the treaty. 1947-2 Cum. Bull. 100, 109. Section 7.519, subparagraph (c), of T. D. 5569 provides:

> "(c) *Beneficiaries of an Estate or Trust.*—A nonresident alien who is a resident of the United Kingdom and who is a beneficiary of a domestic estate or trust, shall be entitled to the exemption, or reduction in the rate of tax, as the case may be, provided in Articles VI, VII, VIII, IX and XIV of the convention with respect to dividends, interest, royalties, natural resource royalties, rentals from real property and capital gains to the extent such item or items are included in his distributive share of income of such estate or trust if he is taxable in the United Kingdom on such income and is not engaged in trade or business in the United States through a permanent establishment."

The United Kingdom Convention does not authorize the issuance of interpretive regulations by either of the contracting parties. The above quoted regulation was issued under Section 62 of our domestic Internal Revenue Code, which authorizes the Commissioner generally to prescribe regulations "for the enforcement of this Chapter", i.e., Chapter 1 of our Internal Revenue Code. 1947-2 Cum. Bull. 109.

Specification of Errors

The Court below erred in the following particulars:

1. In concluding that the capital gains involved in this case represent taxable income to the plaintiff herein and that such gains do not qualify as exempt from taxation.

2. In concluding that plaintiff is not entitled to recover in this action.

3. In concluding that the complaint should be dismissed.

4. In entering judgment in favor of defendants.

5. In failing to enter a judgment for plaintiff as prayed in the Complaint.

Statement of Facts

The plaintiff, American Trust Company, is a California corporation with its principal place of business in San Francisco. Since February 28, 1938, it has been and still is the trustee of the Tevis trust created under the will of Harry L. Tevis (R. 33).

The will of Harry L. Tevis was duly admitted to probate on August 19, 1931, and on July 26, 1935, the Superior Court of the County of Santa Clara duly made and rendered a final decree of distribution ordering the distribution by the executors to the trustees of the trusts created under the will, including the trust here involved, and such a distribution to the trustees was duly made. The corpus of the trust here involved constituted a portion of the property distributed to the trustee of such trust under the final decree of July 26, 1935 (R. 35, 41).

Harry L. Tevis, the decedent, died unmarried and without children. Under his will he bequeathed certain specific legacies in cash to named individuals, created four

trusts in equal amounts for each of the four sons of his brother, William S. Tevis, and a trust in equal amount for one Edwin Lee Dunlap. By paragraph Seventh of his will (R. 35-8), all the rest and residue of any and all property owned by the decedent at his death was bequeathed as follows:

(a) One-half to the decedent's niece, Florence Fermor-Hesketh;

(b) All of the remaining one-half not disposed of as set forth in subparagraph (c) below in trust for the children of Florence Fermor-Hesketh born before decedent's death, with remainders over, the terms of said trust being set forth in paragraph Seventh, subparagraph (b), of the will;

(c) Out of the one-half not disposed of to Florence Fermor-Hesketh, a named sum in trust for the decedent's brother, William S. Tevis, with remainders over to decedent's four nephews, the sons of his brother, William.

Subparagraph (b) of paragraph Seventh of the will reads as follows:

"(b) All that part of the remaining one-half thereof which is not disposed of by the provisions of subdivision (c) of this paragraph (Seventh) I give, devise and bequeath to Fred T. Elsey, as Trustee,[2] upon the uses and trusts, and for the purposes and with the powers hereinafter specified, namely:

To receive the rents, issues and profits and income of the trust estate, and to pay the net rents, issues, profits and income therefrom in equal shares to the children of my niece Florence Fermor-Hesketh born before my death, or to the survivor or suvivors of them, during their lives, respectively.

[2] Fred T. Elsey served as trustee until February 28, 1938, when the American Trust Company qualified as successor trustee.

If any of the said children of my said niece, Florence Fermor-Hesketh shall have predeceased me leaving issue living at my death, my said trustee shall forthwith transfer, pay over and deliver to the said issue of each of said children who predeceases me (and there is hereby given, devised and bequeathed to the issue living at my death of each of said children of my said niece who shall predecease me) one of as many portions of the said corpus of the trust aforesaid as shall be ascertained by adding together the number of the children of my said niece living at my death and the number of her children who predecease me leaving issue living at my death.

If after my death any of the said children of my niece born before my death shall die leaving issue, then there shall be transferred, paid over and delivered to such issue (and in that event there is hereby given, devised and bequeathed to such issue) one of as many parts of the aforesaid trust fund as shall be ascertained by adding together the number of the children of my said niece living at my death and the number of her children who predecease me leaving issue living at my death.

If upon the death of the last of the children of my said niece born before my death and after the issue of each of them who left issue either living at my death, or born thereafter, shall have received the portion of the trust fund which it is hereinabove provided shall be delivered to them, there shall be any overplus in the hands of such trustee, said overplus shall be then transferred, paid over and delivered (and, in that event, there is hereby given, devised and bequeathed) to the then living issue of the said children of my said niece in equal shares per capita and not per stirpes."

Florence Fermor-Hesketh, the decedent's niece, has had five children who were born prior to decedent's death, namely, Thomas S. Fermor-Hesketh born October 7, 1910; Louise Fermor-Hesketh Stockdale born December 15, 1911, Flora Fermor-Hesketh Baring Lawson born February 23, 1913, Frederick Fermor-Hesketh born April 8, 1916, and

John Breckinridge Fermor-Hesketh born March 7, 1917. Florence Fermor-Hesketh had no child who predeceased the decedent and at the time of the decedent's death no child of Florence Fermor-Hesketh had predeceased the decedent leaving issue living at the decedent's death (R. 38-9).

The first child, Thomas S. Fermor-Hesketh, died on June 21, 1937, without issue. Thus in 1946 and at the institution of this suit there were living four life beneficiaries, each of whom was entitled to receive one-quarter of the trust income (R. 39).

During 1946 there were in being five grandchildren of Florence Fermor-Hesketh, namely, three children of Flora Fermor-Hesketh Baring Lawson, the first of whom, John Baring, was born on December 2, 1934, and the other two on August 16, 1938, and August 14, 1946, respectively, and the two children of Louise Fermor-Hesketh Stockdale, one born on May 30, 1938, and the other on January 7, 1940. All of these direct lineal descendants were and are unmarried (R. 39). Since 1946 five additional grandchildren have come into being, all of whom are minors and unmarried and are citizens and residents of the United Kingdom (R. 43-4).

Upon the death of each of the four children of Florence Fermor-Hesketh living in 1946, the trust in respect to one-fifth of the corpus will terminate and the remainder fall in.[3] But since Thomas S. Fermor-Hesketh died without issue, one-fifth of the corpus is an "overplus" which the trustees will retain until the death of the last of the children to die, on which event such overplus will be divided equally between the then living issue of Florence Fermor-Hesketh's children in equal shares per capita (R. 38).

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[3] One of these four, Frederick Fermor-Hesketh, died on June 17, 1955.

The four children of Florence Fermor-Hesketh and her five grandchildren in existence in 1946 were in 1946 and are residents of the United Kingdom within the compass of the United Kingdom Income Tax Convention (R. 39-40). They were all born, domiciled in and subjects, citizens and residents of the United Kingdom; since the dates of their respective births they have continued to be domiciled in and subjects, citizens and residents of the United Kingdom; they have lived continuously in the United Kingdom; they have all been educated in the United Kingdom and, when married, they have married citizens and residents of the United Kingdom; and their friends, interests and affairs have all centered in the United Kingdom (R. 42-4). Such children and grandchildren were not in 1946 and never have been citizens of the United States; they were in 1946 and always have been resident of the United Kingdom for the purposes of the United Kingdom income tax, and were not in 1946 and never have been resident in the United States for purposes of the United States income tax; they were not and never have been engaged in trade or business in the United States; and did not have in 1946 and never have had a permanent establishment situated within the United States (R. 41-2).

During 1944 and 1945 and at all times since then, under the system of income taxation in the United Kingdom of Great Britain and Northern Ireland a charge or tax is imposed upon income but not upon realized accretions of capital; a resident or non-resident individual, a corporation or a trustee of an express trust who realizes gains or profits on the sale of securities or real and other property in the United Kingdom is not chargeable with income tax (including surtax), the excess profits tax or the national defense contribution (in 1946 renamed the profits tax) unless what is done is not merely a realization or change of investment but an act done in what is truly the carrying on or carrying

out of a business; subject to the foregoing, an accretion of capital is not taxable income merely because the original capital was invested in the hope and expectation that it would rise in value, and if it does rise in value the realization on a sale does not result in taxable income (R. 45-6).

In view of this state of the United Kingdom law, if the sales which the plaintiff as trustee made in 1946 of part of the property comprising the corpus of the Tevis trust had been made by a trustee of a trust created in the United Kingdom in terms of the Tevis trust here involved, they would have been in realization on and changes of investments within the foregoing rule of the United Kingdom law, and the gains or profits realized on such sales would not have been subject to the United Kingdom income tax (R. 46).

Under the terms of the Tevis trust and the laws of California, the gains and profits realized on the sales made by the plaintiff as trustee in 1946 were not distributable to the life beneficiaries of the trust, but the entire proceeds of the sales, including the profit thereon, were required to be and were retained by the trustee as part of the corpus of the trust, and the income taxes, if any, arising from such sales were chargeable against the corpus of the trust (R. 40).

On the sales of the securities in 1946, the plaintiff as trustee realized $2,574,000 in cash (R. 41). Following the sales, the plaintiff reinvested the cash proceeds (after setting aside an amount sufficient to pay the expenses of and taxes on such sales) in securities which were held as part of the corpus of the trust fund. The average rate of return from the securities so purchased out of such proceeds for the succeeding seven-year period, 1947-1953, inclusive, was approximately 3.84% (R. 45). As a consequence of the capital gains tax imposed on account of such sales, the income of the four life beneficiaries of the

trust in the aggregate was reduced by about $22,000 each year.

The major tax burden falls upon the remaindermen. The taxes here involved amount to $590,957.86. This amount was charged to and reduced the corpus of the Tevis trust. Unless relief is accorded, the principal of the trust belonging to the British remaindermen is reduced by $590,957.86.

Summary of Argument

1. The capital gains here involved are exempt from United States tax under Article XIV of the United Kingdom Income Tax Convention, which provides in broad and simple language: "A resident of the United Kingdom" shall be exempt "from United States tax on gains from the sale * * * of capital assets". Section 22(b)(7) of the Internal Revenue Code makes the exemption an integral part of our revenue statutes.

2. The exemption in Article XIV must be determined under the treaty, in view of Section 22(b)(7). Our domestic rules of taxing the income of trusts are irrelevant unless authorized by the treaty. Construing Article XIV within the four corners of the treaty, the capital gains here involved are made exempt from United States tax.

3. Throughout the treaty the primary objective was the accomplishment of full reciprocity and equality of tax treatment between the nationals of the contracting parties. In a reverse but like situation, the United Kingdom does not impose a tax on capital gains from the sale of property in trust. Article XIV was intended to put the nationals of both parties on the same footing. Unless Article XIV is given the broad interpretation for which we contend, it will be the one article which does not accomplish reciprocity.

4. The analogy of the Court below to a United Kingdom stockholder of a United States corporation which realizes a capital gain on the sale of the corporate property is without force. In Articles VI, XIII and XVI, the treaty specifies in detail the treatment to be accorded corporate stockholders in respect to corporate profits and the taxation of such profits, and in Article II (1) a corporation is defined as a distinct "entity" or "juridical person". Nowhere in the treaty is a trust accorded recognition as an "entity" or "juridical person". The relationship of a stockholder to the corporate assets is fundamentally unlike the relationship of a beneficiary to property held in trust.

5. The approach of the Court below in resolving the issue and its major conclusion of law were fundamentally fallacious. The Court erred in applying "the scheme of taxation" under United States law, *i.e.,* Sections 161 and 162 of our Revenue Code of 1939, thus making the exemption depend on the status of the trustee and not on the status of the remaindermen.

6. In applying the exemption accorded by Article XIV, a distinction between legal and beneficial ownership is unwarranted. The capital gains here involved were income in equitable ownership of the remaindermen, and accordingly qualified for exemption. Under our modern conceptions, there is no material distinction between legal and equitable ownership for tax purposes. *Helvering* v. *Hutchings,* 312 U. S. 393 (1941); *Commissioner* v. *Nevius,* 76 F. 2d 109 (2d Cir. 1935), *cert. denied*, 296 U. S. 591. Concededly, capital gains realized by individuals who are residents of the United Kingdom are exempt under the treaty. The intervention of a trust and a trustee holding only legal title should not affect the exemption, irrespective of the citizenship of the trustee. The beneficiaries of a trust are not *in pari passu* with the stockholders of a corporation.

In the case of gifts in trust, there are as many exemptions as there are life beneficiaries, *Helvering* v. *Hutchings, supra,* but in the case of a gift to a corporation there is only one exemption. See *Heringer* v. *Commissioner*, 235 F. 2d 149 (9th Cir. 1956).

7. It is irrational to make a distinction between distributable and undistributed capital gains in applying the treaty exemption. The language of Article XIV does not permit of such a distinction. Concededly, capital gains are exempt when distributable. It is irrational to deny the exemption when the gains are retained for future distribution. In both cases the gains arise out of a sale made by the trustee, who, holding only legal title, necessarily acts in a representative capacity, and in both cases the burden of the tax falls upon residents of the United Kingdom. Such a distinction would make the exemption depend on local state law declaring whether a capital gain is or is not distributable, when an international convention should have nationwide uniformity of application.

8. An exemption accorded in an international convention overrides our domestic rules of taxation in the absence of an express exception or saving clause in such Convention. In the Swedish Convention (before this Court in *Lewenhaupt* v. *Commissioner,* 20 T. C. 151 (1953), aff'd *per curiam,* 221 F. 2d 227) and in virtually all of our income tax conventions there is a saving clause which expressly recites: "Notwithstanding any other provision of this Convention" the United States may impose income taxes on its citizens, residents or corporations when such taxes are imposed under our domestic revenue laws "as though this Convention had not come into effect". But no such saving clause appears in the United Kingdom Convention, and the Convention as a whole negatives any intention to adopt the rule.

9. Under principles now firmly established, the Convention must be given a liberal construction in support of the rights claimed under it; if it admits of two constructions, the more liberal will be adopted, *Geofroy* v. *Riggs*, 133 U. S. 258 (1890), and cases cited *infra*.

10. Throughout the year of sale all the remaindermen of the trust were qualified citizens and residents of the United Kingdom so that the capital gains were within the exemption, despite the remote possibility of a change in exempt status or of a future shifting of interest within the closed class.

ARGUMENT

I

THE CAPITAL GAINS HERE INVOLVED ARE MADE EXEMPT UNDER THE UNITED KINGDOM INCOME TAX CONVENTION, AND, SINCE AN INTERNATIONAL TREATY, THE CONVENTION IS CONTROLLING.

An international treaty between two sovereign nations is a document which may not be lightly tossed aside. Yet this in effect is what the Court below has done.

The Constitution of the United States (Article VI, Clause 2) declares that all treaties made under the authority of the United States "shall be the supreme Law of the Land". In the case here involved, the Congress has expressly implemented any exemption accorded in our income tax conventions with other nations, for Section 22(b)(7) of our Revenue Code provides broadly that "Income of any kind" shall be exempt from taxation "to the extent required by any treaty".

Since 1936 when Section 22(b)(7) was first enacted, it has been the declared policy of Congress to give full

recognition to treaty provisions in case of any conflict between the treaty and our domestic revenue laws. Section 22(b)(7) was limited to exemptions in treaties, but in 1942 Congress broadened the policy so that it embraced any treaty obligation. Thus in the Revenue Act of 1942 making certain amendments to the 1939 Code, Section 109 entitled "Treaty Obligations" provided:

> "No amendment made by this title shall apply in any case where its application would be contrary to any treaty obligation of the United States."

And again in enacting the Internal Revenue Code of 1954, Congress expressly provided in Section 7852(d):

> "(d) Treaty Obligations.—No provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of this title."

Section 22(b)(7) here controlling exempts from taxation *income of any kind* (clearly broad enough to include capital gains) "to the extent required by any treaty obligation". Article XIV of the United Kingdom Convention is an international obligation which the United States has undertaken and must fulfill. Thus Section 22(b)(7) is a solemn declaration by the Congress that the character and extent of an exemption accorded by a treaty shall be determined within the four corners of the treaty, irrespective of and without regard to the rules prescribed in our domestic revenue statutes, unless the treaty itself contemplates that such domestic rules are applicable.

Yet the Court below rested its decision in the main upon our domestic scheme of taxation as set forth in Sections 161 and 162 of our Revenue Code,[4] declaring that under

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[4] The material parts of these sections of our Revenue Code as they appeared in 1946 are printed in our Appendix.

these sections the trustee of a trust is accountable for and must pay the tax on gains retained for future distribution and since here a United States citizen, the gains are not within the exemption. The Court concedes on the other hand that if such gains are currently distributable, the exemption in the treaty applies.

The United Kingdom treaty aside, under Sections 161 and 162 a trustee of a trust must report the income of the trust, whether in the form of current income or capital gain. The trustee is allowed a deduction on account of amounts currently distributed or distributable, and is required to pay any tax on the balance. In respect of distributable income, the tax is imposed upon the beneficiary-distributee. The Supreme Court of the United States analyzed these sections in *Helvering* v. *Butterworth,* 290 U. S. 365 (1933), and *Freuler* v. *Helvering,* 291 U. S. 35 (1934). Congress, it was said, did not intend that any income from a trust should escape taxation. But in the *Butterworth* case the Supreme Court added significantly "unless definitely exempted".

But the United Kingdom Convention cannot be put aside. It necessarily carries compelling weight. If the Convention, in and of itself, exempts the capital gains here involved, the rules of our domestic revenue statutes cannot be invoked to limit the exemption, unless there is something in the Convention itself which contemplates the adoption of such rules *as part of the Convention.*

We submit that under Section 22(b)(7) of the Internal Revenue Code, the Court must look to the treaty, and the treaty only, in deciding whether the gains here involved are exempt from taxation.

(1)

The exemption accorded by Article XIV embraces capital gains on property held in trust, whether such gains are currently distributable or are retained for future distribution.

We turn now to a consideration of the treaty and the meaning of the word "exempt" as it appears in Article XIV.

Article XIV provides in broad and simple language: "A resident of the United Kingdom" shall be exempt "from United States tax on gains from the sale * * * of capital assets."

It is not disputed that the life beneficiaries and the remaindermen of the Tevis trust fully qualify as residents of the United Kingdom (R. 39-42) and in all other respects meet the requirements of the treaty. Nor is it disputed that the exemption in Article XIV applies to capital gains on the sale of property held by a trustee in trust. The defendants concede, and, indeed, the Treasury Regulations (see p. 4, *supra*) expressly provide, that such gains are exempt when currently distributable, but the defendants contend that the exemption is inapplicable when the gains are held for future distribution.

In either case, whether distributable or undistributable, the gain arises out of the sale of property held in trust. In the case of a distributable gain, the trustee, not the life beneficiary, decides whether a sale shall be made and if so at what price, and the trustee, not the beneficiary, takes the necessary steps to effect a sale and does the act which transfers the legal title to the purchaser. Thus it is evident that the exemption accorded by Article XIV applies to the gains of the sale of property held in trust, a limited exemption, say the defendants, but they necessarily concede that Article XIV applies in respect of the sale of property in trust.

Thus the issue narrows down to whether Article XIV also applies to gains on the sale of trust property when the

gains are retained for future distribution. It is not the applicability of Article XIV to gains on property in trust, but, rather, the *extent* of the applicability which is the major issue here in dispute.

The Court below attributed to the word "exempt" a technical and quite out of the ordinary meaning of the term in common use. The word, it is said, applies narrowly to "the taxpayer", *i.e.,* the particular individual who, under our domestic scheme of taxation, is primarily liable for the tax, although not the ultimate bearer of the tax.

Unless the capital gains here involved are exempt, the United Kingdom remaindermen unquestionably sustain the amount of the tax, even though not technically "the taxpayer". The word "exempt" as used in Article XIV is, we submit, broad enough to embrace the capital gains here involved.

The word "exempt" is nowhere defined in the treaty. The generally accepted meaning of the word, as defined in our standard dictionaries of the English language, is "to free, except, or excuse from some burdensome condition or obligation, or the operation of some law to which others are subject". Funk & Wagnalls New Standard Dictionary of the English Language, 1947 Edition, p. 872. The 1950 edition of the same publication, p. 348, carries a secondary meaning, "free or excused from some burden or obligation: as *exempt* from taxation".

Our courts have not infrequently adopted and applied this meaning. *Maine Water Co.* v. *City of Waterville,* 93 Me. 586, 45 Atl. 830, 833 (1900); *In re the Matter of Sowers,* 60 N. C. 459, 461 (1864); *Koenig* v. *Omaha & N. W. R. Co.,* 3 Neb. 373, 380 (1874); *Florer* v. *Sheridan,* 137 Ind. 28, 36 N. E. 365, 369 (1894). Thus in *Maine Water Co.* v. *City of Waterville, supra,* the Supreme Court of Maine said:

> "The term 'exemption' implies a release from some burden, duty, or obligation. It is a grace, a favor, an immunity; taken out from under the general rule, not to be like others who are not exempt:"

The nearest approach to what might be considered a definition in the treaty is in Article II, subparagraph (3), which is couched in very general language. This subparagraph provides that "any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting Party relating to the taxes which are the subject of the present Convention", namely, income taxes, surtaxes and excess profits taxes (Article I). But in our own revenue laws, the word "exempt" is not limited in meaning to an exemption of "the taxpayer"; it frequently denotes an "exclusion" and not relief from a personal or individual "liability". In certain instances it is coupled with and used interchangeably with the word "credits", as, for example, in Section 25 authorizing "the following credits against net income", including "An exemption of $600 for the taxpayer" and additional "exemptions" of $600 for his spouse and for each dependent. Frequently the word is used interchangeably with the phrase "there shall be excluded from gross income", as in Section 22(b) and Section 116. Indeed, Section 22(b) reads "The following items shall not be included in gross income and shall be exempt", which necessarily embraces capital gains "to the extent required" by the United Kingdom Convention. Sometimes the word "exempt" attaches to a described individual, sometimes it attaches to the item itself, regardless of the recipient of the item, as in the case of so-called tax exempt income in the form of interest from government, state and municipal bonds under Section 22(b)(4).

Thus there is no precise measure for the meaning of the word "exempt" as it appears in Article XIV. The commonly accepted meaning of the word in current use, namely, to "free or excuse" from "some burdensome condition" or "release" from "some burden affecting other persons", fully justifies the meaning for which we contend. There is nothing in the context requiring a more limited and technical import. On the contrary, the context supports our view. There is no requirement (such as appears in some

of our income tax conventions) that the gain is exempt "when realized by" a resident of the United Kingdom, with the possible implication that the United Kingdom resident must have made the sale to qualify for exemption. The language used was quite different—far broader and more inclusive: "A resident of the United Kingdom * * * shall be exempt from United States tax on gains from the sale or exchange of capital assets".

Indeed, the treaty itself indicates that "exempt" is used in a broad, non-technical meaning. In Article III, relieving from tax under certain circumstances the industrial and commercial profits of an enterprise of either of the two contracting parties, the phrase "shall not be subject to" is used interchangeably with "exempt". Thus the implication in the treaty itself is that any resident of the United Kingdom shall not be subject to the tax, that is to say, shall be relieved from the tax, irrespective of the person who in the first instance may pay the tax.

The words of Mr. Justice Oliver Wendell Holmes in *Towne* v. *Eisner,* 245 U. S. 418, 425 (1918) are not without significance here: "A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used."

(2)

Throughout the treaty the main objective was the accomplishment of full reciprocity between the nationals of the contracting parties; unless Article XIV is given the broad interpretation for which we contend, it will be the one article which does not accomplish reciprocity.

In interpreting Article XIV, the several articles of the treaty and the treaty as a whole may be considered, in an effort to determine the intent of the negotiators. *In re Ross,* 140 U. S. 453, 457 (1891). If, from a consideration of the

several articles, it appears that in each full reciprocity and equality of tax treatment was accomplished so far as practicable, it is reasonable to conclude that Article XIV was no exception, and that complete, not partial, exemption from United States tax was intended. The exemption here claimed is entirely practicable.

The Court below rejected our argument predicated upon reciprocity, saying (R. 28) that in a like but reverse situation the United States beneficiaries are not taxed because there is no capital gains tax in the United Kingdom, thus implying that reciprocity in a treaty exists only in the case of express reciprocal provisions. The Court added (R. 29) it was not convinced that perfect equality of tax treatment was intended, saying, quite gratuitously, that the negotiations "usually consist of a series of tax concessions", and therefore "complete reciprocity is seldom possible".

Surely Article XIV, or indeed any article of the treaty, does not need mutually reciprocal *language* if the language employed actually secures reciprocity. Inasmuch as the United Kingdom does not tax capital gains, it was only necessary to exempt residents of the United Kingdom from the United States tax in order to accomplish reciprocity. While Article XIV on its face is a one-way street, the article secures full equality of treatment on account of the state of the law of the United Kingdom.

The Court below recognizes that Article XIV secures a limited reciprocity, namely, where a United Kingdom resident makes the sale or where, in the case of the sale by a trustee, the gain is currently distributable to a United Kingdom resident. But this limited reciprocity sharply discriminates against a United Kingdom remainderman, for in the reverse situation a United States remainderman is not subject to tax.

Thus the question is whether inequality of tax treatment nevertheless was intended and persists under the treaty, in spite of the broad language of Article XIV.

On an analysis of each of the several articles of the Convention, we maintain, without fear of contradiction, that full and complete reciprocity was accomplished throughout the treaty in the situations covered by the treaty, so far as reciprocity could be accomplished.

The treaty contains twenty-four articles. The full text is printed in our Appendix. Of these, seventeen undeniably secure thoroughgoing reciprocity, with mutually reciprocal provisions cast in virtually identical language, namely, Articles I-V, VII, VIII, X, XI, XII and XVIII-XXIV. The remaining articles, namely Articles VI, IX, XIII, XIV, XV, XVI and XVII are not reciprocal on their face, but a close examination of such articles shows that in every instance the contracting parties intended to secure and did secure actual reciprocity, and, in doing so, went far beyond the elimination of double taxation.

Articles VI, IX and XIII illustrate the extent to which the negotiators went in assuring reciprocity, notwithstanding differences in the theories of taxation in the two countries.

Under Article VI, the United States withholding tax on dividends received from a United States corporation by a United Kingdom resident (normally 30%) is reduced to 15%, while on the other hand dividends received by a resident of the United States from a United Kingdom corporation are made exempt from the British surtax. While apparently representing different tax treatment, Article VI in fact achieved exact equality of treatment in the taxation of corporate earnings. When the Convention was adopted, under British law, the corporate profits of a United Kingdom corporation were subject to income tax at a standard rate of 50% paid by the corporation directly to the British Treasury and a national defense contribution of 5%, or 55% in all (R. 46-7). The stockholder obtained a credit for the purpose of the standard or normal tax equivalent to the tax paid by the corporation, but he was required to pay surtax on the entire dividend (R. 46-7).

On the adoption of the Convention, the United States rate on corporate earnings was 40%. Thus by fixing the withholding rate on dividends received from an American corporation by a resident of the United Kingdom at 15% and at the same time exempting our residents from any surtax on dividends from a United Kingdom corporation, the residents of each of the contracting parties bore the same burden of tax on the pool of corporate earnings, at the rate of 55%. The treaty viewed the economic burden of taxation on the pool of corporate earnings as a whole, and, disregarding the identity of the technical "taxpayer" under domestic law, secured full reciprocity with exactitude.

Bearing in mind that a change in tax rates by either country might upset the reciprocal balance achieved by Article VI, the parties added a clause, subparagraph (3) of Article VI, providing that either of the contracting parties might terminate Article VI by written notice on or before June 30th of any year after 1945.

By Article IX the current United States withholding rate of tax on royalties from mines and other natural resources and on rentals from real property derived from sources within the United States by a United Kingdom resident was reduced from 30% to 15%, a rate which applied on the *gross* amount received. On the other hand, similar royalties and rentals from real property from sources within the United Kingdom derived by a United States resident were made exempt from the United Kingdom surtax, but under United Kingdom law were subject to the standard or normal tax at the prevailing 50% rate, a rate which applied on the *net* amount received, *i.e.,* after credits and deductions (R. 47). A 15% tax on the *gross* receipts was approximately equivalent to a 50% tax on the net receipts, and so equality of tax treatment was accomplished between the residents of the two contracting parties.

Thus in the formal Hearings before a subcommittee of the Committee on Foreign Relations when the United Kingdom Income Tax Convention was before the Senate for ratification, printed by the United States Government Printing Office in Washington, a public document (hereafter referred to as the "Senate Report"), it was stated with respect to Article IX:[5]

> "The United States rate of 30 percent is imposed upon the gross amount of such items [natural resource royalties and rentals] without any allowance for deductions. The reduction in the United States rate from 30 percent to 15 percent upon the gross amount of the rentals is intended to constitute a tax burden corresponding as nearly as may be to the British rate of 50 percent upon the net rentals."

In the same hearings, Eldon P. King, a Deputy Commissioner of Internal Revenue, who negotiated the treaty on behalf of the United States, testified:[6]

> "The solution reached in Article IX respecting rentals from real estate and natural resources reflects the reduction in the United States rate of tax on the gross to approximate the British tax on the net income * * *."

Article XIII deals with reciprocal tax credits. It is significant in two important respects. First, in order to achieve reciprocity of tax treatment, the United Kingdom

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[5] Senate Report. p. 23. This statement is in a printed document entitled "Memorandum Prepared for the Committee on Foreign Relations, United States Senate, Relating to the Convention with Great Britain and Northern Ireland with respect to taxes on Income" which was filed at the Hearings. It was prepared under the supervision of Mr. Colin F. Stam, Chief of Staff of the Joint Committee on Internal Revenue Taxation, and hereinafter will be referred to as the "Stam Memorandum".

[6] Senate Report, p. 61.

made a major legal and policy adjustment by agreeing to adopt a provision for foreign tax credits; prior to the Convention, credits against the United Kingdom tax on account of foreign taxes paid were unknown under British law (R. 47). Thus it was stated in the Senate Report with respect to Article XIII:[7]

> "In arriving at the major reciprocal provisions in the British convention, it is important to observe that it was necessary for Britain to modify its existing law through the adoption of credit principles substantially similar to those employed by the United States, * * *. These represented major legal and policy adjustments on the part of Britain * * *."

Second, in providing a credit for foreign taxes, the United States made an important concession, again for purposes of achieving reciprocity. By Article XIII the foreign tax credit allowed United States residents on dividends from a United Kingdom corporation expressly authorizes the inclusion of the United Kingdom standard tax paid by the British corporation to the British Treasury and deducted from the dividend. Thus it is provided that, for purposes of the credit, the United States recipient of a dividend from a United Kingdom corporation "shall be deemed to have paid" the United Kingdom income tax withheld by the paying corporation in respect of such dividend, if the recipient includes in gross income for our purposes the United Kingdom income tax so withheld by the paying corporation.

This represents a major departure from the United States tax law, for prior to the treaty the Commissioner of Internal Revenue maintained and the United States Supreme Court had held in *Biddle* v. *Commissioner,* 302 U. S. 573 (1938) that an American recipient of a dividend

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[7] Stam Memorandum, Senate Report, p. 29.

from a British corporation is not "the taxpayer" in respect of the United Kingdom standard tax paid by the corporation, and accordingly was denied any credit on account of such tax.[8]

Conversely, Article XIII provides that the credit for United States tax, allowed by the treaty for a British recipient of a dividend from a United States corporation, shall include the United States corporate income tax imposed on such corporation in respect of its profits.

Article XIII, consistent with the treaty as a whole, expressly disregards our technical conception of "the taxpayer" and places the nationals of the two countries upon a reciprocal basis.[9]

Articles XIV, XV, XVI and XVII each involved a concession upon the part of the United States only. By each Article, the United States agreed to a tax exemption not otherwise accorded by our tax laws so as to equalize and

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[8] In the course of his testimony, Mr. Colin F. Stam said (Senate Report, p. 71):

> "Now the question came up as to whether or not under the American law this British tax should be regarded as a tax on the corporation. The Supreme Court said in effect, in the Biddle case, that under the concept in this country this is a tax of the corporation, and the law does not permit the shareholder to get credit for the tax. The convention adopts the British concept and allows the shareholder to get the credit. The treatment is reciprocal."

[9] In the course of his testimony, Mr. Eldon P. King said (Senate Report, p. 60):

> "As a part of the solution Britain agreed to treat the United States corporate normal tax and surtax as being borne by the British shareholder, and the United States agreed to treat the British standard tax as being borne by the United States shareholder."

match the United Kingdom rule, which did and does not impose any tax in corresponding situations. The exemptions, altogether unnecessary for eliminating double taxation, were essential only in order to achieve complete mutuality and reciprocity in treatment as between residents of the United Kingdom and residents of the United States.

Article XIV, with which we are here involved, secures mutuality and equality of treatment by eliminating a United States tax in a situation where, in the same but reverse state of affairs, the United Kingdom imposes no tax. In the very nature of the case, it is directed at reciprocity and not at the elimination of double taxation. We shall pass it for the moment and consider Articles XV, XVI and XVII.

Article XV again illustrates the achievement of equality of tax treatment through an exemption of United States tax when, in view of the United Kingdom statutes, no comparable tax was imposed. Again it has nothing to do with the elimination of double taxation. Prior to the treaty, the United States taxed dividends and interest paid to British residents (and other non-resident aliens) by a United Kingdom corporation which was engaged in business in and derived a certain percentage of its gross income from United States sources (20% in the case of interest and 50% in the case of dividends). On the other hand, in the reverse situation the United Kingdom never imposed any tax on dividends and interest from a United States corporation when received by a United States resident even though the United States corporation was engaged in business in and derived a substantial amount of gross income from United Kingdom sources (R. 48). Complete equality of tax treatment was achieved in such situations by Article XV, which exempted from United States tax dividends and interest paid by a United Kingdom corporation except

where the recipient is a United States citizen or resident.[10] This had the desired effect of exempting citizens and residents of the United Kingdom from any United States tax, and so putting the nationals of the two contracting parties upon an exact equality of tax treatment. Thus, in this narrow area where there formerly existed inequality of tax treatment between the two countries, Article XV, representing an important concession by the United States, accomplished complete equality in tax treatment. In purpose and effect, Article XV is quite parallel to the exemption of Article XIV.

As in the case of Articles XIV and XV, Article XVI was adopted to provide an exemption from United States taxes where, in the reverse situation, there was no comparable United Kingdom tax. Again, it has nothing to do with the elimination of double taxation. Unlike our tax acts, the United Kingdom has never undertaken to impose taxes upon corporate accumulated or undistributed earnings (R. 48). Accordingly, in order to insure equality, by Article XVI a United Kingdom corporation engaged in

[10] The Stam Memorandum states (Senate Report, p. 25):

"This article owes its existence to the fact that the United States, unlike the United Kingdom, holds that dividends paid by a foreign (as to the United States) corporation may constitute income from sources within the United States if 50 percent or more of the gross income of such corporation is derived from sources within the United States (sec. 119(a)(2)(B), Internal Revenue Code). Thus, if a United Kingdom corporation derives business or investment income from sources within the United States to the extent of such percentage, the dividends paid by such corporation to its shareholders living in the United Kingdom are, to that extent, income from sources within the United States and hence would be theoretically taxable in the hands of such resident of the United Kingdom. The United Kingdom does not undertake to assert its tax against the dividends paid by a United States corporation deriving income from sources within the United Kingdom. * * * The purpose of the article is, therefore, to reciprocate with the United Kingdom as to taxation of dividends paid by a foreign corporation."

business in the United States is made exempt from the United States tax on its accumulated and undistributed earnings, subject to the limitation that residents of the United Kingdom throughout the last half of the taxable year control more than 50% of the voting power.[11]

Article XVII covers the settlement of delinquent United States taxes due by residents of the United Kingdom under circumstances now covered by Articles XV and XVI. In result, Article XVII makes Articles XV and XVI effective in respect of prior unpaid taxes due by residents and corporations of the United Kingdom. As indicated above, Articles XV and XVI granted exemption from United States taxes which the United Kingdom never imposed, so there was no occasion to make provision for like delinquent taxes of residents of the United States, since none existed.

Certainly, these four articles, all exemptions, bear conclusive testimony of a purpose wholly foreign to the elimination of double taxation. They indicate a dogged intention to create equality of tax treatment in so far as practically possible under the respective tax laws of the two nations.

The presence throughout the treaty of this complete mutuality or reciprocity in treatment as between residents of the United Kingdom and residents of the United States is not surprising. As in the case of all treaties, each of the two contracting parties naturally was motivated by a desire to see that its nationals were placed at no disadvantage when compared with the treatment accorded the nationals of the other contracting party. Besides, in any tax convention between two sovereign nations it is only

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[11] In the Stam Memorandum discussing Article XVI it is said (Senate Report, p. 25):

> "Here again the United Kingdom does not impose tax upon the undistributed profits or surplus of a United States corporation. Hence the article is intended to establish a reciprocity in this regard as between the two countries."

right and proper that the nationals of each of the two countries should not be given any preference but should receive equal treatment in all of the situations covered by the treaty. As our Supreme Court has repeatedly recognized, in international treaties it is invariably the intention of the contracting parties "to secure equality and reciprocity between them". See pages 52-4, *infra*.

The Court below (R. 29) doubted that perfect equality of tax treatment was intended to be accomplished by the Convention, observing that tax conventions usually consist of a series of tax concessions made by each party, and therefore complete reciprocity "is seldom possible". In the Convention under consideration, reciprocity was not accomplished or intended to be accomplished in every conceivable situation, but from what we have said above it is evident that reciprocity *was* intended *in the situations covered by the treaty,* certainly to the extent that reciprocity was possible. Towards this end, both parties to the Convention had to make important concessions, as did the British in the case of tax credits and the United States in the case of certain exemptions, including the exemption accorded in Article XIV.

There are only two possible functions of each Article of the United Kingdom Convention: the elimination of double taxation and reciprocity. In the case of Article XIV double taxation could not possibly be involved. The single purpose behind the adoption of Article XIV was reciprocity. Accordingly, in the absence of an intent to the contrary indicated either by the language of the article itself or by some other article dealing more particularly with the same subject matter, Article XIV should be construed in a manner consistent with such underlying purpose. On the face of the treaty there is no room for an arbitrary half measure of reciprocity.

(3)

The analogy suggested by the Court below to a United Kingdom stockholder of a United States corporation realizing a capital gain on the sale of corporate property is without force.

Nevertheless, the Court below repudiated the reciprocity argument. It said (R. 28) that the reason a United States beneficiary of a United Kingdom trust in a reverse situation would be free from any capital gains tax is because there is no capital gains tax in the United Kingdom, saying that "One could just as well argue that a resident of the United Kingdom who held stock in an American corporation should be free from the burden of United States capital gains taxes on the sale of corporate property".

The analogy to a United Kingdom stockholder in an American corporation is, we submit, quite beside the point. Under the Convention as drafted and under the substantive laws of the contracting parties, there is no place for such an argument, and the analogy is quite unsound. The Convention in Articles VI, XIII and XVI spells out in detail the treatment to be accorded corporate stockholders in respect to corporate profits and the taxation of corporate profits; and the Convention in Article II(1) expressly defines a corporation as a distinct "entity" or "juridical person". Thus it is provided (Article II(1)):

> "(d) The term 'United States corporation' means a corporation, association or other like entity created or organized in or under the laws of the United States.
>
> (e) The term 'United Kingdom corporation' means any kind of juridical person created under the laws of the United Kingdom."

But nowhere in the Convention is a trust accorded recognition as an "entity" or "juridical person". Accordingly, it appears that the Convention itself recognizes the funda-

mental difference in substantive law between the relationship of a stockholder to the corporate assets and the relationship of a beneficiary to property held in trust.

The relationship of a stockholder to the corporate assets is fundamentally different from the relationship of a beneficiary to property held in trust. As stated by the Supreme Court in *Klein* v. *Board of Tax Supervisors,* 282 U. S. 19, 24 (1930), a corporation's "ownership is a nonconductor that makes it impossible to attribute an interest in its property to its members". The corporate assets belong to the corporation; the shares belong to the shareholders and are distinct and independent property. Thus there is only one gift tax exemption in case of a gift to a corporation, notwithstanding the indirect proportionate benefits derived from such gift by the stockholders. See *Heringer* v. *Commissioner,* 235 F. 2d 149 (9th Cir. 1956). However, in the case of gifts in trust, the Supreme Court has held that there are as many gift tax exemptions as there are life beneficiaries of the trust. *Helvering* v. *Hutchings,* 312 U. S. 393 (1941).

Again, under our estate tax law, where a British stockholder of a British corporation dies, and the corporation has assets in the United States, the stockholder is not subject to our estate tax in respect of such assets, since he does not own or have a taxable interest in such assets. On the other hand, if a British beneficiary of a British trust dies, and such trust has assets in the United States, the beneficiary is subject to our estate tax in respect of such assets; he is considered either "the owner" of such assets or as having a taxable interest therein. This was the holding in *Commissioner* v. *Nevius,* 76 F. 2d 109 (2d Cir. 1935), *cert. denied,* 296 U. S. 591, in which Judge Swan observed (p. 110):

> "Equitable interests are so common and so valuable that it is incredible that they should be excluded from taxation. The naked legal title of a trustee during continuance of the trust has no pecuniary value."

(4)

The approach of the Court below was fundamentally fallacious; it erred in making the exemption depend on the status of the trustee and not on the status of the remaindermen.

In view of the foregoing discussion, let us now consider in more detail the approach of the Court below in deciding the issue here presented.

Adopting the contention of the defendants that the capital gain was not the income of the remaindermen but the income of the trustee, which does not qualify for exemption, the Court below said (R. 25) that such contention "is based on a distinction that has long been made in the scheme of taxation of trusts in the United States". And again (R. 30), "The basic issue here is, who is the taxpayer? It is perfectly reasonable for the defendant to follow United States law in making that initial determination", adding that there is nothing in the tax convention to warrant a different conclusion.

On the basis of this approach the Court framed its major conclusion of law as follows (R. 48):

> "The capital gains involved in this case represent taxable income to the plaintiff herein and the plaintiff-trustee does not qualify for any exemption from taxation on that income."

We respectfully dissent from these views. In the absence in the treaty of any express or implied reservation of the right to apply United States law, the exemption in Article XIV should be interpreted and applied without regard to our domestic rules of taxation. This principle would seem to be a self-evident truth.

The exemption in Article XIV is not, we submit, a personal exemption limited only to a United Kingdom resident who reports and pays the tax. The exemption

has a broad, equitable purpose, namely, to exempt capital gains from taxation when a United Kingdom resident *in fact* would otherwise sustain the burden of the tax, that is to say, would "stand the tax", directly or indirectly.

By the very nature of an international treaty which applies equally to the nationals of both of the contracting parties, equality of treatment necessarily is of first importance. A nation would be remiss in its duty to its own citizens if it permitted such citizens to be placed at a disadvantage. In an international treaty which, as here, expressly deals with and, in the case of United Kingdom residents expressly exempts, capital gains from United States tax, the presumption is that the exemption accorded was intended to be broad enough to place the nationals of each of the contracting parties upon equal footing. The issue here, we submit, must be resolved upon a consideration of the treaty in and of itself, uninfluenced by any technical liability imposed upon a trustee under our domestic law, or by the taxable status of the trustee for the purpose of determining liability under our domestic law.

Nevertheless, the Court below persistently gave controlling weight to "the scheme of taxation of trusts in the United States", citing and quoting from *Freuler v. Helvering,* 291 U. S. 35 (1934), "as one of the leading cases".

The "scheme of taxation of trusts in the United States" is as the Court below indicates. But the scheme of taxation under United States law is not necessarily the scheme of taxation under the treaty. Indeed, the scheme of taxation under the treaty necessarily departs from our scheme of taxation for otherwise there would be no need for the treaty. This is particularly true in the case of a broad exemption such as is accorded in Article XIV. A treaty exemption would not be worth much if our domestic law nevertheless continued to apply. From the very nature of the question, our scheme of taxation must give way to a

treaty exemption. The question, therefore, depends on the extent of the exemption *under the treaty.*

In the excerpt quoted by the Court below from the *Freuler* case, the quotation is incomplete. The Supreme Court stated at the outset of the paragraph "Plainly the section contemplates the taxation of the entire net income of the trust". It then pointed out that the fiduciary may be required to accumulate or he may be given a duty currently to distribute it. "If the latter, then the scheme of the act is to treat the amount so distributable, not as the trust's income, but as the beneficiary's", adding, "The test of taxability to the beneficiary is not receipt of income, but the present right to receive it".

But the Court below did not quote a material statement, namely, "This treatment of the beneficiary's income is necessary to prevent the possibility of postponement of the tax to a year subsequent to that in which the income was received by the trustee", and it also did not quote the explanatory statement "If it were not for this provision, the trustee might pay on part of the income in one year and the beneficiaries on the remainder in a later year", thus lessening the tax burden.

Clearly the comments of the Supreme Court in the *Freuler* case quoted by the Court below were directed at the need of insuring the taxation of all the *taxable* income of a trust. It was thus directed at a relatively narrow issue. There was not involved and the Supreme Court did not consider the effect of an exemption upon the taxation of trust income. But in *Helvering* v. *Butterworth, supra,* where the Supreme Court adopted the same interpretation of Sections 161 and 162, the Supreme Court did consider the effect of an exemption, for it said (p. 369):

> "Certainly, Congress did not intend any income from a trust should escape taxation unless definitely exempted."

Under our domestic statute law, in the case of a trust under which the remainderman is a charitable organization, the trustee is allowed a deduction on account of capital gains retained and permanently set aside for the remainderman and credited to corpus, and so such gains are not subject to tax. See Section 162(a) of the 1939 Code, our Appendix pp. 24a-25a; *United States* v. *Benedict*, 338 U. S. 692 (1950); *Commissioner* v. *Central Hanover Bank*, 163 F. 2d 208 (2d Cir. 1947); *Commissioner* v. *Bonfils Trust*, 115 F. 2d 788 (10th Cir. 1940). The fact that the trustee (who is not exempt) is "the taxpayer" does not affect the exemption.

Again, under our statutory withholding provisions, the payor in the first instance pays the tax and shifts the burden to the payee by deducting the amount of the tax from any distribution. If the payee is exempt, he may come forward and claim refund of the entire amount of tax reported and paid by the payor. The exemption does not depend upon the status of the payor, but it depends upon the status of the distributee, even though he is not technically "the taxpayer".

In *Estate of Emily Tait* v. *Commissioner*, 11 T. C. 731 (1948), a United States fiduciary claimed a deduction with respect to income distributable to a Canadian citizen when, under the Income Tax Convention with Canada (56 Stat. 1399), such income was exempt in the hands of the Canadian beneficiary. The Tax Court disallowed the deduction. The United States fiduciary, it said, was the taxpayer and, not being a resident of Canada, did not qualify for the exemption. Following an appeal taken by the taxpayer to the United States Court of Appeals, the case was remanded to the Tax Court on stipulation by counsel for both parties. Whereupon the Commissioner concurred in the taxpayer's contentions and the Tax Court entered a final decision of no deficiency. The Treasury issued a ruling repudiating the original *Tait* decision, I. T. 4019, 1950 Cum. Bull. 58, stating:

> "To disallow the deductions in such cases would have the effect of taxing income which is specifically exempted by treaty."

and, after citing *Helvering* v. *Butterworth, supra,* the ruling concluded:

> " * * * if the income is 'definitely exempted' by treaty provisions, effect must be given to such provisions."

In its decision the Court below failed to give any weight to the fact that the capital gains here involved were equitably owned by United Kingdom remaindermen; it made an irrational distinction between distributable and undistributable gains; and it failed to take into account that the United Kingdom treaty did not contain the so-called standard saving clause appearing in all our prior income tax conventions.

(a) In applying the exemption accorded by Article XIV, a distinction between legal and beneficial ownership is unwarranted; the capital gains here involved were income in equitable ownership of the remaindermen and accordingly were exempt.

The Court below failed to recognize that for tax purposes equitable ownership under a trust is of equal dignity with legal ownership. The Court said (R. 30) that a basic condition of recovery is a showing that the capital gains here taxed were income of the beneficiaries of the trust, who alone qualify for the exemption, and that there is nothing in the Convention to indicate an intention to treat the capital gains as income of the beneficiaries.

We submit that the Court below erred in so holding. Article XIV is in general terms. It concededly applies to capital gains on the sale of property individually owned by a resident of the United Kingdom, and, in the case of the sale of property held in trust, it concededly applies to gains which are currently distributable to a United Kingdom life beneficiary. There is nothing in the language of

Article XIV which denies the exemption in the case of trust capital gains retained for future distribution, which occurs on the death of the life beneficiary and may happen in the year following the sale. Until a distribution occurs, the United Kingdom remaindermen are the equitable owners of the capital gains. There is no indication that a resident of the United Kingdom must hold the legal title to the property sold, in order to enjoy the exemption.

On the date of sale in 1946 all the beneficiaries of the trust qualified as residents of the United Kingdom. They were the equitable owners of the property sold, of the proceeds of the sale, and of the resulting capital gains. The Court below said that the capital gains were not "income" of the remaindermen. On the contrary, in equitable ownership these gains constituted profits belonging to the remaindermen in the year when realized, and will be distributed to such remaindermen on the death of the life tenants. For trust accounting purposes, such gains were credited to capital, but they represented very real earnings derived from the trust corpus and in truth and substance were income of the United Kingdom remaindermen in equitable ownership.

The fact that the trustee, an American corporation, held the legal title and as trustee effected the sale on behalf of the beneficiaries should not, we submit, render the capital gains taxable, in the face of the treaty exemption. So to hold is to exalt form over substance, in applying an international tax convention. We believe that the intervention of a trust and a trustee having legal title should not bar the exemption, when in the year of sale the beneficiaries were the equitable owners of the capital gains and qualified for the exemption. Such a rule is sound in principle and is supported by the adjudicated cases.

In *Commissioner* v. *Nevius, supra,* the intervention of a British trust and a British trustee holding legal title did not bar the imposition of estate taxes on a British bene-

ficiary in respect of that portion of the trust *res* which had a situs in the United States. In the majority opinion, Judge Swan suggested that if a distinction between legal and equitable ownership exists, equitable ownership is of greater significance than legal ownership, observing (p. 110):

> "Equitable interests are so common and so valuable that it is incredible that they should be excluded from taxation. The naked legal title of a trustee during the continuance of the trust has no pecuniary value."

In his concurring opinion, Judge Learned Hand held that the British beneficiary "owned and held" the trust *res*, stating (p. 111):

> "* * * it would, I think, quite contradict the whole scheme of the title to import a distinction between legal and equitable interests, whatever view one takes of equitable interests * * *. Only lawyers make that distinction today and not many even of them; it would be pedantic to impute it to Congress, even in a tax statute."

In *Helvering* v. *Hutchings, supra,* the intervention of a trust and a trustee holding legal title did not bar separate gift tax exemptions in respect of each of the several beneficiaries of the trust. The Supreme Court held that in the case of gifts in trust there are as many gift tax exemptions as there are life beneficiaries of the trust, notwithstanding the fact that the gift was made to one trustee. The Supreme Court reasoned (p. 397):

> "In the face of an exemption thus made broadly applicable to all gifts to all donees and in the absence of some indication of an intention to discriminate between gifts made directly to the donees and those made indirectly to the beneficiaries of a trust, we can hardly assume a purpose to favor one class of donees over the other * * *."

Compare *Heringer* v. *Commissioner, supra,* involving a gift to a corporation with a limited number of stockholders, which cited and distinguished the *Hutchings* case. As we have already seen (p. 32, *supra*), the relationship of stockholders to the corporate assets and of the beneficiaries of a trust to the trust property is fundamentally dissimilar.

Our courts have been realistic in disregarding the formal technicality of legal title, not only for estate tax purposes as in *Commissioner* v. *Nevius, supra,* and gift tax purposes as in *Helvering* v. *Hutchings, supra,* but also for income tax purposes. *Lederer* v. *Stockton,* 260 U. S. 3 (1922). In *Lederer* v. *Stockton* the Supreme Court held that the income of a non-exempt trust was exempt when an exempt beneficiary was in practical but not legal possession of the income. At the time the *Lederer* case was decided, there was no specific statutory provision for the Supreme Court's disposition of the case; the case arose prior to the adoption in our statutes of an exemption for a trust or estate in respect of income permanently set aside for a charity.

The *Lederer* case dealt with a trust which was an "active trust" under the appropriate local rules, with a gift over to a charity. The Supreme Court of Pennsylvania had held that the income on the bequest in trust could not be paid to the charity until the death of a life annuitant, and that until such event occurred the income must remain in the control of the trustee under the will. Faced with this situation, the trustee transferred the entire bequest as a loan to the hospital secured by a mortgage on the hospital property, under the terms of which the hospital would pay only interest enough to satisfy the administrative charges and the remaining annuity, using the remainder of the income for its own purposes. The Government contended that the trust as interpreted by the Supreme Court of Pennsylvania was an active trust and one which

could not be terminated, and accordingly the income in question was not "income received" by a charity and so not within the exemption. Nevertheless, the Supreme Court held that the income was exempt. Mr. Chief Justice Taft said (p. 8):

> "As the Hospital is admitted to be a corporation, whose income when received is exempted from taxation under § 11(a), we see no reason why the exemption should not be given effect under the circumstances. To allow the technical formality of the trust, which does not prevent the Hospital from really enjoying the income, woud be to defeat the beneficent purpose of Congress."

The *Lederer* case was cited with approval by the United States Court of Appeals for the Seventh Circuit as recently as March 4, 1954. See *Arthur Jordan Foundation* v. *Commissioner,* 210 F. 2d 885, 888 (1954).

In support of its position the Court below relied on our domestic scheme of taxation in Sections 161 and 162 of the 1939 Code. These provisions were designed to provide fair and convenient administration of our domestic income tax laws in the case of estates and trusts and the beneficiaries of trusts, and to insure that income of an estate or trust is to be taxed to either the fiduciary or the beneficiary, and that it may not escape tax by falling in some way between the two. *Freuler* v. *Helvering, supra; Helvering* v. *Butterworth, supra.* To impose the tax with respect to accumulated income of a trust on the beneficiaries would create hardship, but not to tax it in the hands of the trustee would permit outright avoidance. On the other hand, to tax income in the hands of a trustee which, but for the intervention of the trust, would be exempt should not, in the absence of clear intent to the contrary, be allowed in applying Article XIV of the treaty. Our revenue laws no doubt intend to tax the entire income of a trust, but always sub-

ject to the limitation "unless definitely exempted". *Helvering* v. *Butterworth, supra; Estate of Emily Tait* v. *Commissioner,* discussed on p. 36, *supra.*

Unquestionably the negotiators could have drafted Article XIV in such manner either to exclude all gains on the sale of property held in trust by a United States trustee, or to exclude gains which are accumulated for future distribution. But Article XIV was not so drafted. Unlike the provisions in the treaty providing particular rules for other types of income (such as in Articles VI, VII, VIII and IX), Article XIV contains no express requirement that the gains, to be exempt, must be "derived by" or "realized by" the United Kingdom resident.

There is no reasonable justification for distinguishing between legal and equitable interests in applying the exemption in respect of capital gains. Indeed, it would contradict the whole scheme of the Convention to import such a distinction in Article XIV, since, in a number of instances, the Convention disregards the identity of the technical "taxpayer" under our domestic law in order to establish broad equitable rules and mutual reciprocity of treatment. See Articles III(3), IV, VI and XIII.

(b) It is irrational to make a distinction between distributable and undistributed capital gains in applying the treaty exemption.

In looking only to see who is the formalistic "taxpayer" under United States law, the Court below was forced to make a distinction between distributable gains (which he held were exempt) and accumulated gains (which he held were not within the exemption). This is a wholly irrational distinction under an international treaty exemption broad enough to embrace both.

In both instances the gains arise on the sale of property held in trust; the trustee holds the legal title of the

property sold; the trustee decides whether a sale shall be made, and if so, when and at what prices; the trustee is accountable, in the case of an improvident sale, to the life beneficiary or to the remainderman, as the case may be. In the case of a distributable gain, the trust property sold is not first distributed and the sale made by the distributee; the sale is made by the trustee and only the gain is distributed. In one instance the life beneficiary is the formal taxpayer and in the other the trustee is the formal taxpayer. But in both instances the economic burden of the tax falls on the beneficiaries and not upon the trustee.

Whether the gain is distributable or not distributable, the trustee acts in a representative capacity only. In either case he shifts the economic burden of the tax. In the former case the life beneficiary bears the economic burden for he must pay the tax, unless exempt. In the latter case, while the trustee initially pays the tax, the economic burden of the tax is shifted to the remaindermen, unless they are exempt. Whichever way the tax may be shifted, either to the life beneficiary or to the remainderman, the controlling factor, in all equity and justice, should be whether he upon whom the economic burden of the tax falls is exempt, not whether the trustee is exempt.

From the standpoint of equity and natural justice, there is no inherent reason for exempting distributable gains and taxing gains retained for future distribution, which ultimately will be distributed. Under our statutory law, income of a trust which is currently distributable to a charitable organization is exempt, and in the case of a charitable remainder the retained and undistributed income is exempt in the hands of the trustee (p. 36, *supra*). There is no reason why the same rule should not apply under a treaty exempting residents of the United Kingdom from the United States tax on capital gains. It is inconceivable that the negotiators of the United Kingdom did not intend

that the exemption follow the ultimate burden rather than apply only where the United Kingdom resident is formalistically "the taxpayer".

Furthermore, where profit arises on the sale of property held in trust, in the absence of any direction in the trust instrument the profit is distributable or is retained for future distribution depending upon the law of the state under which the trust is created, which varies between states. Surely an exemption in an international treaty should be applied uniformly throughout the United States and not made dependent upon the differing laws of the several states. Such a result is quite unthinkable.

(c) The Swedish treaty and its analysis in the *Lewenhaupt* case recently before this Court serves to show that under the United Kingdom Convention the status of the trustee is not controlling.

In final analysis the reasoning and the conclusions of law of the Court below rest upon the continued right of the United States to impose the capital gains taxes on the plaintiff-trustee, a United States corporation, notwithstanding the United Kingdom Convention and as though it had not come into effect. This perhaps would have been true had the United Kingdom Convention contained the standard "saving clause" appearing in all of our income tax conventions negotiated prior to the United Kingdom Convention and in virtually all of our income tax conventions negotiated since.[12] Its omission in the United Kingdom Convention is of the utmost significance.

[12] The "saving clause" has appeared in all our income tax conventions prior to the United Kingdom Convention, namely, Canada (March 4, 1942—56 Stat. 1399); France (July 25, 1939—59 Stat. 893); and Sweden (March 23, 1939—54 Stat. 1759). Since the United Kingdom Convention, all of the 15 subsequent conventions have included a saving clause except the conventions with New Zealand, Ireland and Australia.

This so-called "saving clause" expressly secures to the United States the right to impose United States income, excess profits taxes and surtaxes upon its citizens, or residents or corporations, "notwithstanding any other provisions of this convention" and "as though this convention had not come into effect", but securing to the United States citizen the foreign tax credit on account of foreign taxes, if any, imposed upon such citizen.

Thus under our income tax convention with Sweden, effective January 1, 1940 (54 Stat. 1759), which was before this Court in *Lewenhaupt* v. *Commissioner,* 20 T. C. 151 (1953), affirmed *per curiam,* 221 F. 2d 227 (1955), "for the reasons given by the Tax Court", Article XIV provided:

> "It is agreed that double taxation shall be avoided in the following manner:
>
> (a) Notwithstanding any other provisions of this convention, the United States of America in determining the income and excess-profits taxes, including all surtaxes, of its citizens or residents or corporations, may include in the basis upon which such taxes are imposed all items of income taxable under the revenue laws of the United States of America as though this convention had not come into effect. The United States of America shall, however, deduct the amount of the taxes specified in Article I (b) (1) and (3) of this convention or other like taxes from the income tax thus computed but not in excess of that portion of the income tax liability which the taxpayer's net income taxable in Sweden bears to his entire net income."

There was a similar and reciprocal provision securing the same rights to Sweden under Swedish law.

The Swedish treaty and all our other treaties containing the saving clause are important, not because of the specific issue arising under it and involved in the *Lewenhaupt* case, but because of the effect which the Tax Court gave to the presence of the saving clause on the right of the United

States to impose taxes upon its own citizens, residents and corporations in accordance with the provisions of our domestic revenue laws and irrespective of the treaty provisions.

In the *Lewenhaupt* case a Swedish citizen realized a capital gain on the sale of real estate located in the United States. Article IX of the Swedish treaty provides that gains derived from the sale of capital assets in the United States by a resident of Sweden "shall be exempt from taxation in" the United States when such resident has no permanent establishment in the United States. But Article V states that capital gains derived from the sale of real estate "shall be taxable only in the contracting State in which the real property is situated".

If the general exemption under Article IX was controlling, there would have been no tax on the gain, United States or Swedish, but if the general exemption did not include gains on real estate sales, the United States could collect one tax under our statutory law taxing gains on the sale of real estate situated in the United States. The Tax Court upheld the tax on the latter theory, adding, however, that on the facts found the taxpayer in any event did not qualify for exemption under Article IX as he had a permanent establishment in the United States.

In its consideration of the Swedish treaty, the Tax Court stated at the outset (p. 160): "The purpose of the tax convention is the avoidance of double taxation"; continuing, the Tax Court said "It was not designed, as the petitioner urges here, to exempt a class of income from taxation by both of the contracting states". Quoting from the Senate Executive Report on the treaty, the Tax Court pointed out that "each specific item of income [was] made subject to tax in one or the other of the two countries but not in both". The Tax Court concluded that Article XIV

of the Convention [above quoted] "was made the key provision" by means of which the avoidance of double taxation, *i.e.,* the imposition of one tax but not two, was rendered possible.

That is to say, the presence of the saving clause in the Swedish treaty served to permit either the United States or Sweden, as the case might be, to continue to tax its own citizens and residents in accordance with the respective revenue laws of each nation, "notwithstanding any other provision of this convention" and "as though this convention had not come into effect".

Assuming that the same issue as is here involved had arisen under the Swedish treaty, the saving clause probably would have preserved the right of the United States to tax the plaintiff-trustee under our domestic scheme of taxing trusts. But in the absence of any saving clause, the clear implication of the Tax Court's analysis of the Swedish treaty in the *Lewenhaupt* case is that no rights under United States law are preserved, aside from rights expressly secured to the United States in the treaty itself.

In reading into the United Kingdom Convention the standard saving clause, the Court below said (R. 30) that there is nothing in the tax convention that would not warrant the defendant in following United States law. On the contrary, absent the saving clause, there is nothing *in* the Convention which *does* warrant the application of United States law. Our domestic revenue laws should not be invoked to limit an otherwise all embracing treaty exemption. This would appear to be the declared policy of Congress in view of the presence in our statutory law of Section 22(b)(7).

The United Kingdom Convention is quite unlike the Swedish treaty and prior treaties in a number of material

respects. In many instances, double taxation is eliminated but, unlike the former treaties, the United Kingdom treaty does not invariably insure the imposition of one tax. In a number of cases it relieves the item of income from taxation by either nation, as in Articles XIV, XV and XVI. It does not contain the standard saving clause, although such a saving clause was ready at hand had the contracting parties intended to preserve to the United States (and to the United Kingdom) the rights secured under it. Its omission is persuasive evidence that the United Kingdom was unwilling to accept it, and intended that the treaty should be applied in accordance with its terms, unaffected by our statutory law.

For example, Article XIII, for the purposes of the foreign tax credits, permits a United States stockholder of a British corporation to take into account the British standard tax paid by the British corporation to the British Treasury, contrary to United States statutory law as interpreted by the Supreme Court in the *Biddle* case (discussed above, p. 25). This was done to insure complete reciprocity in respect of the taxes imposed by the two nations on corporate earnings. Had a saving clause been inserted in the treaty, it would probably have vitiated Article XIII. Without it, the rule of the treaty definitely controls. So in the case of Article XIV. If the treaty exempts the capital gains here involved, as we submit it does, the treaty must control, without regard to our domestic statutory law.

The Administrative Regulations under the Two Treaties

Before leaving the Swedish treaty and the *Lewenhaupt* case, it seems appropriate to consider briefly the administrative regulations issued under the two treaties and the sanctions for such regulations.

Article XXI of the Swedish treaty expressly authorizes "The competent authorities of the two contracting States" to prescribe "regulations necessary to interpret and carry out the provisions of the Convention."[13] Thus the regulations issued under the Swedish treaty have the express sanction of the treaty itself.

This is not the case in respect of the United Kingdom treaty. Unlike the Swedish treaty, the United Kingdom treaty contains no authority for the issuance of administrative regulations. T. D. 5569 was promulgated under the general power in Section 62 of the 1939 Code, authorizing the Commissioner to issue regulations "for the enforcement of this chapter", namely, the income tax chapter of our domestic Revenue Code.

There is treaty authority for the weight which the Tax Court gave to the administrative regulations under the Swedish treaty. But in the absence of any express sanction in the United Kingdom treaty for administrative regulations, Section 7.519(c) of T. D. 5569 (quoted above on p. 4) is to be viewed with skepticism insofar as it falls short of giving full recognition to Article XIV, certainly where the rights of a United Kingdom remainderman are involved.

But whatever the weight of T. D. 5569 may be, the regulation is not "conclusive upon courts called upon to construe" a treaty, *Factor* v. *Laubenheimer*, 290 U. S. 276, 295 (1933); and a regulation which "operates to create a rule out of harmony with the statute, is a mere nullity". *Manhattan General Equipment Co.* v. *Commissioner*, 297 U. S.

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[13] "ARTICLE XXI

The competent authorities of the two contracting States may prescribe regulations necessary to interpret and carry out the provisions of this convention. * * *"

129, 134 (1936). The courts repeatedly have refused to follow administrative regulations.[14]

We should perhaps point out a patent defect in the language of the regulation. It is stated that a United Kingdom resident "who is a beneficiary of a domestic trust" shall be entitled to the exemption or reductions in the rate of tax with respect to "dividends, interest, royalties, natural resource royalties, rentals from real property and capital gains" when such items are included in his distributed share "if he is taxable in the United Kingdom on such income and is not engaged in trade or business in the United States through a permanent establishment". Capital gains realized by a trust are not subject to tax in the United Kingdom, whether the trust is a United Kingdom trust or a United States trust. Thus, the qualify-

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[14] See, for example, *Trust of Bingham* v. *Commissioner*, 325 U. S. 365 (1945); *Manhattan General Equipment Co.* v. *Commissioner*, 297 U. S. 129 (1936); *Campbell* v. *Galeno Chemical Co.*, 281 U. S. 599 (1930); *Lynch* v. *Tilden Co.*, 265 U. S. 315 (1924); *International Railway Co.* v. *Davidson*, 257 U. S. 506 (1922); *United States* v. *Grimaud*, 220 U. S. 506 (1911); *Williamson* v. *United States*, 207 U. S. 425 (1908); *Commissioner* v. *Mills*, 183 F. 2d 32 (9th Cir. 1950), affirming 12 T. C. 468 (1949); *Rickenberg* v. *Commissioner*, 177 F. 2d 114 (9th Cir. 1949), *cert. denied* 338 U. S. 949; *Essick* v. *United States*, 88 F. Supp. 23 (S. D. Calif. 1949), *appeal dismissed per stip.*, 9th Cir. Aug. 29, 1950; *Commissioner* v. *Philip J. LoBue*, 223 F. 2d 367 (3d Cir. 1955), affirming 22 T. C. 440 (1954); *Commissioner* v. *Produce Reporter Co.*, 207 F. 2d 586 (7th Cir. 1953), affirming 18 T. C. 69 (1952); *Commissioner* v. *Clark*, 202 F. 2d 94 (7th Cir. 1953), affirming 17 T. C. 1357 (1952); *Lincoln Electric Co. Employees' Profit-Sharing Trust* v. *Commissioner*, 190 F. 2d 326 (6th Cir. 1951); *Kimbrell's Home Furnishings, Inc.* v. *Commissioner*, 159 F. 2d 608 (4th Cir. 1947); *Burnet* v. *Marston*, 57 F. 2d 611 (App. D. C. 1932), affirming 18 B. T. A. 558; *Higgins* v. *Foster*, 12 F. 2d 646 (2d Cir. 1926); *Community Water Service Co.* v. *Commissioner*, 32 B. T. A. 164 (1935). In at least one case the Government itself in effect attacked the treasury regulations and the Court of Appeals for the Fifth Circuit upheld the Government. *F. H. E. Oil Co.* v. *Commissioner*, 147 F. 2d 1002 (5th Cir. 1945).

ing clause "if he is taxable in the United Kingdom on such income", while appropriate in the case of the other recited items, is entirely inappropriate in respect to a capital gain. Indeed the treaty itself imposes the same limitation with the sole exception of capital gains under Article XIV.

Only one other provision of T. D. 5569 is at all pertinent. Section 7.514 sets forth the specific classes of income from sources within the United States which are considered exempt under the Convention. Among these are:

> "(g) Gains from the sale or exchange of capital assets by a nonresident alien who is a resident of the United Kingdom or by a foreign corporation managed and controlled in the United Kingdom, if such alien or corporation has no permanent establishment in the United States."

This subparagraph is appropriate when applied in the case of property directly owned by a resident of the United Kingdom. It does not undertake to apply to property held in trust, which is specifically dealt with in Section 7.519(c). But if Section 7.514(g) were considered as having general application, its limited language, "Gains from the sale * * * of capital assets by a nonresident alien", does not reflect the broad language of Article XIV, "A resident of the United Kingdom * * * shall be exempt from United States tax on gains from the sale * * * of capital assets". Section 7.514(g) is certainly not fully responsive to the language of the treaty exemption.

II

AN INTERNATIONAL CONVENTION WILL BE LIBERALLY CONSTRUED, AND IF IT ADMITS OF TWO CONSTRUCTIONS THE RIGHTS CLAIMED UNDER IT WILL PREVAIL.

The claim here involved is in substance a claim made by a resident of the United Kingdom under an income tax Convention between the United Kingdom and the United States. In the case of any doubt arising as to the meaning of the treaty, it is now firmly established under a long line of Supreme Court decisions that the treaty will be liberally construed, and where the treaty admits of two constructions, one restrictive of the rights that may be claimed under it and the other more favorable, the more favorable will prevail.

This principle has its origin in the Constitution of the United States and the inherent nature of an international treaty. Article VI, Clause 2, of our Constitution declares that the Constitution, the Laws of the United States made in pursuance thereof and all Treaties "shall be the supreme Law of the Land". Since a treaty and an act of Congress are put upon the same footing, it has been held that where a conflict arises between a treaty and a federal statute, the later in point of time will prevail, although a mere re-enactment of an existing statute does not displace the treaty. *Cook* v. *United States,* 288 U. S. 102, 118 (1933); *United States* v. *Lee Yen Tai,* 185 U. S. 213 (1902). Here, however, necessarily there can be no conflict between the United Kingdom treaty and our Revenue Code inasmuch as Section 22(b)(7) expressly excludes from gross income and makes exempt "Income of any kind, to the extent required by any treaty obligation * * *."

The rules for the construction of a treaty differ from the rules construing a taxing statute or a private contract. Of course the search for the intent of the contracting par-

ties is of primary importance, and in determining such intent all of the provisions of the treaty must be examined in the light of the attendant and surrounding circumstances. *In re Ross*, 140 U. S. 453, 457 (1891); *Rocca* v. *Thompson*, 223 U. S. 317, 331 (1912).

But here the similarity of the rules for construction end. The Supreme Court, recognizing that a treaty constitutes a solemn compact between two independent and sovereign nations, each motivated by a desire to protect its own nationals, has repeatedly declared that a treaty will be accorded a liberal construction so as to carry out the intent of the contracting parties and secure the evident purpose of the treaty, namely, equality and reciprocity. Further, the Supreme Court decisions make it perfectly clear that where a treaty admits of two constructions, one restrictive of rights that may be claimed under it and the other more favorable to the claimant, the latter is to be preferred.

An early and leading case is *Geofroy* v. *Riggs*, 133 U. S. 258 (1890). In the *Geofroy* case a treaty with France insured equality between the nationals of the two countries with respect to the possession and disposal of personal and real property "in all the states of the union", and, with respect to France, "within its territories". The claimant, a citizen of France, asserted the right to inherit real estate in the District of Columbia. Unless the phrase "states of the union" included such political bodies as the District of Columbia and our territories, full reciprocity would not be attained. In upholding the claimant the Supreme Court said (p. 271):

> "It is a general principle of construction with respect to treaties that they shall be liberally construed, so as to carry out the apparent intention of the parties to secure equality and reciprocity between them. As they are contracts between independent nations, in their construction words are to be taken in their ordinary meaning, as understood in the public law of nations, and not in any artificial or special sense impressed upon them by local law, unless such re-

> stricted sense is clearly intended. And it has been held by this court that where a treaty admits of two constructions, one restrictive of rights that may be claimed under it and the other favorable to them, the latter is to be preferred."

In announcing the rule set forth in the final sentence of the above quotation, the Supreme Court cited *Hauenstein* v. *Lynham,* 100 U. S. 483, 487 (1879). In the *Lynham* case, which involved a treaty with Switzerland, the Supreme Court categorically stated:

> "Where a treaty admits of two constructions, one restrictive as to the rights, that may be claimed under it, and the other liberal, the latter is to be preferred. *Shanks* v. *Dupont,* 3 Pet. 242. Such is the settled rule in this court."

The Supreme Court decisions have never departed from these principles. The leading cases are *Jordan* v. *Tashiro,* 278 U. S. 123 (1928); *Nielsen* v. *Johnson,* 279 U. S. 47 (1929), and *Factor* v. *Laubenheimer,* 290 U. S. 276 (1933). The later decisions have reaffirmed these principles. See *Choctaw Nation* v. *U. S.,* 318 U. S. 423, 431 (1943); *Bacardi Corp.* v. *Domenech,* 311 U. S. 150, 163 (1940); *Valentine* v. *Neidecker,* 299 U. S. 5, 10 (1936).

By the very nature of an international treaty, reciprocity and equality of treatment between the nationals of the two contracting parties is a major purpose. Assuredly, the negotiators for the United Kingdom had in mind the interests of their own nationals in agreeing to the language of Article XIV. In the absence of any capital gains taxes in the United Kingdom on gains realized on property held in trust, the purpose of the United Kingdom negotiators was to accomplish reciprocity so far as reciprocity could be accomplished. But if any doubt arises as to the extent of the exemption claimed by non-residents of the United Kingdom under Article XIV, the construction most favorable to the claimant should, we submit, prevail.

III

THROUGHOUT THE YEAR OF SALE ALL THE REMAINDERMEN QUALIFIED AS CITIZENS AND RESIDENTS OF THE UNITED KINGDOM SO THAT THE CAPITAL GAINS WERE WITHIN THE EXEMPTION, DESPITE THE REMOTE POSSIBILITY OF A CHANGE IN EXEMPT STATUS OR A FUTURE SHIFTING OF INTEREST WITHIN THE CLOSED CLASS.

The remote possibility of a change of exempt status in later years, or the possibility of a future shifting of interest within the closed class, does not affect the exemption.

Throughout 1946, the year when the sale occurred, all the beneficiaries were citizens and residents of the United Kingdom and fully qualified within the treaty. Had the sale in 1946 involved securities owned in legal ownership, the status of the seller in the year of sale would have controlled, regardless of any likelihood of his losing his status in later years. The same would be true with respect to distributable gains on the sale of property in trust. There is no logical basis for a different rule when the gains are retained if all the remaindermen throughout the year of sale are citizens and residents of the United Kingdom.

Analogous situations exist under our revenue laws and the Convention itself. Under Section 162(a) of our Code and Regulations 118, Section 39.162-1, income of a trust, including capital gains, "paid or permanently set aside" for a charity is exempt. *Hopkins* v. *Commissioner,* 13 T. C. 952 (1949). In view of the language "permanently set aside", the bequest must be free from any possibility of failure. Both the courts and the Treasury view as controlling the exempt status of the remainderman during the taxable year when the capital gain is realized. S. M. 4644,

V-1 Cum. Bull. 277; A. R. R. 521, 4 Cum. Bull. 221. The same rule is applied in the case of estate taxes where there is a bequest to a qualified charity, even though in a later year the charity may lose its exemption by engaging in "prohibited transactions". See Regulations 105, Section 81.46.

Under the United Kingdom Convention, Article XVI exempts a United Kingdom corporation from United States tax on its accumulated and undistributed earnings if throughout the last half of the taxable year United Kingdom residents control, directly or indirectly, more than 50% of the voting stock. There is no requirement that the stockholders must be residents of the United Kingdom in the year when such stockholders ultimately receive the accumulated earnings either by dividend or liquidation. The facts existing at the time the tax is imposed are controlling.

In any event, in view of the admissions in the answer (R. 10-11, 18) and the findings of the Court below (R. 42-4) there is little or no likelihood that prior to the death of the four life beneficiaries (Florence's children) the lineal descendants of Florence will not remain citizens and residents of the United Kingdom.

The second possibility is a change of interest by deaths and births within the class. The trust was irrevocable and the gifts over were limited to a class embracing the lineal descendants of the testator's niece, Florence (R. 37-8).

Under the so-called New York rule and the rule of the *Restatement of Property,* on the birth of the first grandchild of Florence (John Baring, in 1934—R. 39) the remainder vested in him and remained vested subject to contraction or divestment by later births or deaths within the class. The New York rule grew out of the New York courts' interpretation of the New York Property Law defining vested and contingent remainders enacted in 1830 (Rev. Stat. N. Y., Part II, Chap. 1), which provided:

> "§ 13. Future estates are either vested or contingent. They are vested, when there is a person in being, who would have an immediate right to the possession of the lands, upon the ceasing of the intermediate or precedent estate. They are contingent, whilst the person to whom, or the event upon which they are limited to take effect, remains uncertain."

In 1896 the plural was changed to the singular. It now appears as Section 40 of the New York Property Law (McKinney's Consolidated Laws of N. Y. Annotated).

The leading New York cases are: *Moore* v. *Littel,* 41 N. Y. 66 (1869); *Baker* v. *Lorillard,* 4 N. Y. (4 Comst.) 257 (1850); *Coster* v. *Lorillard,* 14 Wend. (N. Y.) 265, 301-2 (1835); *Campbell* v. *Stokes,* 142 N. Y. 23, 36 N. E. 811 (1894); *Crackanthorpe* v. *Sickles,* 156 App. Div. 753, 141 N. Y. Supp. 370 (1st Dep't 1913); *United States Trust Co.* v. *Wheeler,* 73 App. Div. 289, 76 N. Y. Supp. 707 (1st Dep't 1902), aff'd, 173 N. Y. 631, 66 N. E. 1117 (1903).

California has adopted the New York rule. The California Code was enacted in 1872, and the Code followed precisely the language of the New York definitions, except for the interpolation of the words "defeasible or indefeasible" in the third line of the definition of a vested remainder. Sections 694 and 695 provide:

> "§ 694. Vested interests. A future interest is vested when there is a person in being who would have a right, defeasible or indefeasible, to the immediate possession of the property, upon the ceasing of the intermediate or precedent interest.
>
> § 695. Contingent interests. A future interest is contingent, whilst the person in whom, or the event upon which, it is limited to take effect remains uncertain."

Thus under Section 695 of the California Code the remainder of the Tevis trust was contingent until the birth

in 1934 of John Baring, the first grandchild. Upon that event, Section 694 was satisfied since "there is a person in being who would have a right", whether "defeasible or indefeasible", to "the immediate possession of the property" upon "the ceasing of the precedent estate".

The California courts interpreting Sections 694 and 695 have followed the New York courts and adopted the New York rule. *In re DeVries,* 17 Cal. App. 184, 119 Pac. 109 (1911), citing and quoting (p. 202) from the leading New York case of *Moore* v. *Littel, supra; Gray* v. *Union Trust Co.*, 171 Cal. 637, 154 Pac. 306 (1915), citing and quoting from *Crackanthorpe* v. *Sickles, supra.*

Thus in 1946 when the sale here involved occurred, the five grandchildren of Florence had an equitable vested remainder, and although the interest might shift due to later deaths and births within the class, the class was closed and embraced only the lineal descendants of Florence, all citizens and residents of the United Kingdom.

As we have already seen (pp. 37-42, *supra*), such an interest constitutes equitable ownership and such ownership embraced the ownership of the capital gains here involved. These gains represented in substance income to the equitable owners, all of whom qualified as residents of the United Kingdom.

Having in mind the broad reach of Article XIV as evidenced by its language, the evident intent to accomplish full reciprocity and equality of tax treatment so far as such reciprocity was attainable, the equitable ownership of the capital gains which the United Kingdom remaindermen enjoyed and the undoubted economic tax burden which would otherwise fall upon them, we respectfully submit that such gains were intended to be and are under Article XIV of the treaty and Section 22(b)(7) of our Code "exempt from United States tax".

CONCLUSION

It is respectfully submitted that the judgment of the Court below should be reversed with costs, and that it be ordered and adjudged that judgment should be entered in favor of the plaintiff in the sum of $570,957.86, with interest thereon as provided by law, as prayed for in the complaint.

Respectfully submitted,

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Dated: San Francisco, January 31, 1957.